(1)

90-6 01

No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1990

EDWARD G. WEBB, MARILYN K. WEBB,
Petitioners,

vs.

UNITED STATES OF AMERICA,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. When the Internal Revenue Service proposes to enter into an arrangement with a third party, which could substantially prejudice the taxpayer whose tax liability is involved, does the Internal Revenue Service have a duty to notify the taxpayer and provide the taxpayer an opportunity to object?

2. When the Internal Revenue Service agrees at the request of any person other than the taxpayer, to subordinate a tax lien, securing the taxpayer's tax obligation pursuant to 26 C.F.R. §301.6325-1(d)(2), does the Internal Revenue Service have a duty to notify and obtain the consent of the taxpayer who is ultimately liable for the tax?

3. Did the District Court abuse it discretion in denying the Internal Revenue Service a judgment against the taxpayers when the Internal Revenue Service, by its own decision and without the knowledge or consent of the taxpayers, took an action which resulted in the loss of a tax lien on property which could have been enforced to discharge the tax obligation?

PARTIES TO THE PROCEEDING

1. The United States of America (Internal Revenue Service) — Plaintiff in the original action to reduce a federal tax lien to judgment, Appellant in the appeal to the Ninth Circuit Court of Appeals and Respondent herein.

2. Edward G. Webb and Marilyn K. Webb — Defendants in the original action brought by the United States, third-party Plaintiffs in a third-party complaint against Chula & May, a law corporation, George H. Chula and Alan M. May; Appellees in the appeal before the Ninth Circuit Court of Appeals and Petitioners herein.

3. Chula & May, a law corporation, George H. Chula and Alan M. May, third-party Defendants in the underlying action, their default was taken on April 27, 1988, however, no judgment has been entered against them.

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In The
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EDWARD G. WEBB, MARILYN K. WEBB,
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vs.
UNITED STATES OF AMERICA,
Respondent.

PETITION FOR WRIT OF CERTIORARI

The Petitioners respectfully pray that a Writ of Certiorari issue to review the decision of the United States Court of Appeals for the Ninth Circuit.

OPINIONS BELOW

Neither the decision of the U.S. District Court for the Central District of California, nor the decision of the U.S. Court of Appeals for the Ninth Circuit was certified for publication. True and correct copies of the judgments of the District Court and of the Ninth Circuit Court of Appeals are attached hereto as Appendix A and B, and incorporated herein by reference.

JURISDICTION

Petitioners seek review by this Court of the decision of the United States Court of Appeals for the Ninth Circuit, which was entered on July 11, 1990 in the matter of *United States of America v. Edward G. Webb and Marilyn K. Webb*, No. 89-55299 (District Court for the Central District of California No. CV-87-7842-RG). Jurisdiction to review this decision by Writ of Certiorari is conferred on the Supreme Court by Title 28 U.S.C. §1254(1). There are special and important reasons for review of this decision on Writ of Certiorari because it involves a decision by a United States Court of Appeals on an important question of federal law which has not, but should be, settled by the Supreme Court (Supreme Court Rule 10.1(c)). Specifically, this case raises the issue of whether, in a case where the taxpayer can be severely prejudiced by a discretionary action on the part of the Internal Revenue Service, the Internal Revenue Service has a duty to notify the taxpayer of its proposed action, even though the Internal Revenue Service regulations do not expressly require notice.

STATUTE AND REGULATION INVOLVED

Title 26 U.S.C. §6325(1)(d) states:

> "(d) Subordination of lien.
> Subject to such regulations as the Secretary may prescribe, the Secretary may issue a certificate of subordination of any lien imposed by this chapter upon any part of the property subject to such lien if —

"(1) there is paid over to the Secretary an amount equal to the amount of the lien or interest to which the certificate subordinates the lien of the United states,

"(2) the Secretary believes that the amount realizable by the United States from the property to which the certificate relates, or from any other property subject to the lien, will ultimately be increased by reason of the issuance of such certificate and that the ultimate collection of the tax liability will be facilitated by such subordination, or

"(3) in the case of any lien imposed by section 6324B, if the Secretary determines that the United States will be adequately secured after such subordination."

Title 26 C.F.R. §301.6325-1(d) states:

"(d) Subordination of lien — (1) By payment of the amount subordinated. A district director may, in his discretion, issue a certificate of subordination of a lien imposed under Chapter 64 of the Code upon any part of the property subject to the lien if there is paid over to the district director an amount equal to the amount of the lien or interest to which the certificate subordinates the lien of the United States. For this purpose, the tax lien may be subordinated to another lien or

interest on a dollar-for-dollar basis. For example, if a notice of a Federal tax lien is filed and a delinquent taxpayer secures a mortgage loan on a part of the property subject to the tax lien and pays over the proceeds of the loan to a district director after an application for a certificate of subordination is approved, the district director will issue a certificate of subordination. This certificate will have the effect of subordinating the tax lien to the mortgage.

"(2) To facilitate tax collection — (i) In general. A district director may, in his discretion, issue a certificate of subordination of a lien imposed under Chapter 64 of the Code upon any part of the property subject to the lien if the district director believes that the subordination of the lien will ultimately result in an increase in the amount realized by the United States from the property subject to the lien and will facilitate the ultimate collection of the tax liability."

STATEMENT OF THE CASE

Summary

The issues presented in this case arise out of the action by the Internal Revenue Service (IRS), without notice to the taxpayers, agreeing with the then owner of the property, pursuant to 26 C.F.R. §301.6325-1(d), to

subordinate its tax lien. The owner was not the taxpayers who are personally liable for the taxes, but a third party who acquired the property from the taxpayers subject to the tax lien. The subordination agreement between the IRS and the property owner was made without the taxpayers' knowledge or consent. The IRS agreed to subordinate to a new loan, the proceeds of which were to be used in part to remodel the residence. The IRS believed that by subordinating its lien to permit remodeling, the value of the property would be increased to the extent that, upon subsequent resale, more funds would be generated to satisfy the tax obligation.

The property owner almost immediately defaulted on payment of the refinancing loan and the lender foreclosed on the property, wiping out the tax lien and leaving no excess proceeds to be applied to the tax liability. As a result, the IRS realized substantially less from the property under the subordination arrangement than it would have had it simply foreclosed, and the amount for which the taxpayer remained liable was equally greater.

Although the IRS had no specific statutory obligation to notify the taxpayers of its intention to enter into a subordination agreement, the District Court for the Central District of California found that where the potential for prejudice is so great and the burden of notification is minimal, the IRS had an equitable duty to notify and obtain the consent of the taxpayers to the subordination. The IRS gambled with the security for the tax obligation and lost and, thereafter, looked to the taxpayer to pay the price of the IRS's bad investment. Under the circumstances, the taxpayer should have been notified and have had an opportunity to object to the IRS subordination before the damage was done. On appeal by the

IRS, the Ninth Circuit reversed by decision on July 11, 1990.

Facts

In July, 1982, the IRS caused a notice of lien to be recorded in the records of the County Recorder of Orange County, California, for taxes which the taxpayers, Edward G. Webb and Marilyn K. Webb (hereinafter referred to as the "taxpayers"), had reported owing for the taxable year 1980, but had failed to pay. Upon recordation, the IRS tax lien attached to certain real property then owned by the taxpayers located at 11201 Meads, in the City of Orange, Orange County, California (hereinafter referred to as "the property"). In October, 1983, the taxpayers conveyed the property to Chula & May Law Corporation (hereinafter referred to as "Chula & May") subject to the tax lien, and for a consideration which reflected the diminished value of the property due to the tax lien. At the time of the sale of the property, it was understood by the parties that in the normal course of business, Chula & May would have to pay off the tax lien upon any refinance of the property, or upon sale of the property to convey clear title. At that time the Webb's tax liability would be satisfied. This understanding was reflected in the agreement between the Webbs and Chula & May for the sale of the property. The IRS has characterized this agreement for the sale of the property as a "secret agreement" and implies that the Webbs and Chula & May were intentionally concealing some material information from the IRS. In fact, the agreement was a simple purchase and sale agreement which was no more "secret" than any other of the millions of agreements entered into every day to which the IRS is not a party. The agreement

made it clear that the property was being sold subject to the IRS lien and that it was the responsibility of the buyers, Chula & May, to discharge the tax lien when they refinanced or sold the property. In any event, this agreement is irrelevant to the issue of whether the IRS had a duty to notify the taxpayer of its intention to subordinate the tax lien when a third-party owner of the property is involved.

After acquiring the property, Chula & May approached the IRS with a request that the IRS agree to subordinate its lien to a new deed of trust securing a loan in a sufficient amount to pay off all prior liens and encumbrances on the property (except the tax lien) and provide funds for repair and remodeling of the property so that it could potentially be sold at a substantially increased price at a later date, sufficient to satisfy the balance of the tax liability of the Webbs. As part of the transaction, some but not all of the tax lien would be satisfied from the refinance. According to the IRS estimate, if the property were sold at a tax sale, the proceeds would not be sufficient to satisfy the entire tax liability after payment of the liens and encumbrances on the property, which were prior to the IRS lien. Notwithstanding that determination by the IRS, Chula & May were able to negotiate a loan secured by the property which would have been more than sufficient to pay all the prior liens and encumbrances and the IRS tax lien. In 1985, the IRS agreed, however, to subordinate the tax lien to the loan obtained by Chula & May in return for payment of only about half of the tax liability. It was anticipated by the IRS that the property would be sold as soon as the remodeling and repairs were completed, and that the proceeds of sale would be sufficient to pay off the new loan and the balance of the federal tax liability.

The IRS expectations proved to be wrong. Soon after refinancing, Chula & May defaulted on the payments of the new loan, and allowed the property to be sold at a trustee's sale under the deed of trust to which the IRS had subordinated. There were no excess proceeds from the trustee's sale to be paid against the tax obligation. Having been disappointed in its venture with Chula & May, the IRS immediately brought suit in the United States District Court for the Central District of California to obtain a personal judgment against the taxpayers, Mr. and Mrs. Webb, for the balance of the tax liability. This was the first notice the taxpayers received of the deal between the IRS and Chula & May, and by this time it was too late to object.

The IRS had never attempted to notify the Webbs, or obtain their consent to the subordination of the tax lien, although the Webbs had the most at risk because it was their tax liability and they were ultimately liable for paying the tax. The District Court found that, under these circumstances, the IRS had an equitable duty to notify and obtain the consent of the taxpayers prior to agreeing to subordinate the tax lien. The District Court further found that sufficient funds were generated from the refinancing of the property to pay the entire amount of the tax liability (had the IRS demanded full payment) and that the failure of the IRS to notify the taxpayers of the proposed subordination deprived the taxpayers of any opportunity to mitigate their liability. The District Court concluded that:

> "In the absence of any binding requirement requiring notice and in the interest of equity, the smaller burden of notifying the taxpayer of negotiations to subordinate is greatly outweighed by the possibility of

> actual prejudice resulting from the lack of notice."
>
> Judgment of the U.S. District Court at p. 2.

The District Court granted judgment in favor of the Defendants, the taxpayers Mr. and Mrs. Webb, and denied a judgment for the balance of taxes for the IRS. There was a third-party complaint by the taxpayers against Chula & May in which the default of Chula & May had been taken. The District Court ruled that in view of the judgment in favor of the taxpayers, no judgment on the third-party complaint was warranted.

The United States brought an appeal in the Ninth Circuit Court of Appeals alleging that the District Court erred in denying the IRS judgment on the tax liability because it failed to give notice to the taxpayers of the subordination agreement. The Court of Appeals reversed and remanded the case to the District Court stating:

> "We hold that the IRS did not have a duty, legal or equitable, to inform the Webbs of the subordination.
>
> "Since the IRS had no legal duty to inform the Webbs of the intended subordination, the IRS did not breach any legal duty owed to the Webbs .... The IRS, when requested to subordinate its tax lien to facilitate acquisition of new financing, had the authority to subordinate the lien, and did so believing that its actions were in the best interests of all involved.
>
> ***

> "... our holding does no more than require the Webbs to be responsible for a legitimate tax debt, due and owing.
>
> ***
>
> "The IRS acted within the law in granting the subordination, and had no legal duty to notify the Webbs."
>
> Memorandum of Decision of the U.S. Court of Appeals for the Ninth Circuit, p. 3-4.

When the Webbs sold their property to Chula & May, they accepted, as consideration, less than the market value of the property in the reasonable expectation that the IRS would enforce its lien against the property and their tax liability would be satisfied in that manner. When the IRS chose to subordinate the tax lien for less than full payment, it was reasonable for the IRS to notify the taxpayers that it intended to relieve the property of any further liability for the tax.

FEDERAL JURISDICTION

The underlying action was filed by the United States of America in the United States District Court for the Central District of California seeking to obtain a judgment against Edward G. Webb and Marilyn K. Webb for unpaid federal income tax assessments. The District Court had jurisdiction over the matter pursuant to Section 7402 of the Internal Revenue Code (26 U.S.C. §7402) and under 28 U.S.C. §§ 1340 and 1345.

REASONS FOR GRANTING THE WRIT

This case presents important issues of federal law which have not been, but should be, settled by the Supreme Court (Supreme Court Rules, Rule 10.1(c)). Specifically, the issues are whether an equitable duty should be imposed on the Internal Revenue Service to notify a taxpayer before subordinating the tax lien of the taxpayer when the action would substantially prejudice the taxpayer and, if so, whether it was an abuse of discretion for the District Court to deny the Internal Revenue Service a judgment on the tax liability when the IRS failed to give notice, and the subordination resulted in the loss of security for payment of taxes. While there is no specific statutory requirement that the IRS notify the taxpayer when it proposes to enter into agreement with a third party to subordinate the existing tax lien against the taxpayer, the great potential for prejudice to the taxpayer and the minimal burden on the IRS of giving notice would support the existence of an equitable duty to deal fairly with the taxpayer and provide the taxpayer notice of its intention to subordinate.

I

FAILURE TO NOTIFY A TAXPAYER OF A PROPOSAL TO SUBORDINATE A TAX LIEN AFFECTING HIS LIABILITY HAS THE POTENTIAL OF SUBSTANTIALLY PREJUDICING THE TAXPAYER'S INTERESTS

The Internal Revenue Code authorizes the Secretary of the Treasury to subordinate a tax lien under certain circumstances:

> "Subject to such regulations as the Secretary may prescribe, the Secretary may issue a certificate of subordination of any lien imposed by this chapter upon any part of the property subject to such lien if —
>
> "(1) there is paid over to the Secretary an amount equal to the amount of the lien or interest to which the certificate subordinates the lien of the United States,
>
> "(2) the Secretary believes that the amount realizable by the United States from the property to which the certificate relates, or from any other property subject to the lien, will ultimately be increased by reason of the issuance of such certificate and that the ultimate collection of the tax liability

will be facilitated by such subordination, ..."

26 U.S.C. §6325(1)(d).

The Secretary has issued Section 301.6325-1(d) of Title 26 of the Code of Federal Regulations to implement Section 6325(1)(d), which reads in relevant part as follows:

"(d) Subordination of lien

(1) By payment of the amount subordinated

***

(2) To facilitate tax collection —
(i) In general. A district director may, in his discretion, issue a certificate of subordination of a lien imposed under Chapter 64 of the Code upon any part of the property subject to the lien if the district director believes that the subordination of the lien will ultimately result in an increase in the amount realized by the United States from the property subject to the lien and will facilitate the ultimate collection of the tax liability.

26 C.F.R. §301.6325-1(d).

The authority granted to the Secretary under 26 U.S.C. §6325(1)(d) and to a district director of the IRS under §301.6325-1(d)(2) is essentially the authority to enter into a speculative joint venture with the owner of property subject to a tax lien in anticipation of being able to increase the value of the property and satisfy

more of the tax liability. However, as with all speculative ventures, there is the possibility of failure and loss. If the property does not increase in value as expected, the IRS may lose the security for the tax liability and be limited to a personal claim against the taxpayer. The taxpayer still has the tax liability and has lost property from which he could satisfy the tax obligation. This risk may be justified when it is the taxpayer who enters into the speculative joint venture with the IRS; however, when the IRS enters into such a venture with a *third party* without the knowledge or consent of the taxpayer, and gambles with the taxpayer's tax liability, the taxpayer should not be made to suffer the consequences of the miscalculation, bad judgment or bad luck of the IRS.

The facts of this case are not so unusual as to indicate that it is unique and will not occur again in the future. When people are in financial difficulties, one indication of which is inability to pay their taxes, they are often forced to sell property subject to existing tax liens for a discounted price reflecting the existence of those liens. The reason for the discounted price is that the parties expect that the tax liens will remain on the property until the buyer pays off the tax obligation which they secure, or until the IRS enforces the liens at a tax sale. The taxpayer has not escaped the payment of his "legitimate tax debt" because the tax obligation remains secured by the property, even when the property is placed in the name of a third person. If the new owner is able, without consent of the taxpayer, to persuade the IRS to release or subordinate the tax lien to another encumbrance for less than full payment of the tax liability, the taxpayer is prejudiced because the security for the tax obligation is removed. The taxpayer remains ultimately responsible for payment of the tax.

The IRS' knowledge of the written agreement between the Webbs and Chula & May is not relevant to the issue of notice or resulting prejudice to the Webbs from the IRS action. The prejudice results from the fact that the security for the payment of the tax is reduced. When, as here, the lien evidences a personal obligation of the taxpayer/seller of the property, the seller is prejudiced by the IRS waiving their lien rights and pursuing a personal action against the taxpayer. The so-called "secret agreement" between the Webbs and Chula & May did nothing to change this result. The Webbs would have been prejudiced by the IRS agreement to subordinate whether or not the written agreement existed, therefore, the IRS's lack of knowledge of the agreement is immaterial.

When the IRS agrees with a third-party buyer to release or subordinate a tax lien on real property for less than full payment of the tax liability, it violates the reasonable expectations of the taxpayers that the real property is security for the tax obligation. It also violates the reasonable expectations of the taxpayers and the buyer when they agreed to the price at which the property was sold. A subordination agreement with a third person without notice to the taxpayers puts the taxpayers at risk by gambling with the security for the payments of their tax obligation and subjecting the taxpayers to the potential for increased personal liability. Because a subordination agreement with a third-party buyer of property subject to a tax lien has such substantial potential for prejudice to the taxpayers, it is inequitable to allow the IRS to take such a risk without notifying and obtaining the consent of the taxpayers. The IRS admitted that had the IRS known of the written agreement between the Webbs and Chula & May, it would have given notice to the Webbs of the proposed

subordination. Since the existence of the agreement had no effect on the potential for prejudice to the taxpayers, the IRS has in effect admitted that it should have given notice to the taxpayers in any event. The taxpayers are the ones to suffer most by the IRS decision to subordinate, therefore, notice to the taxpayer should be given whenever a subordination agreement is entered into with a third party.

II

THE LACK OF A STATUTORY REQUIREMENT SPECIFICALLY MANDATING NOTICE SHOULD NOT DEPRIVE THE COURT OF THE ABILITY TO EXERCISE ITS BROAD EQUITABLE POWERS

There is no requirement in the provisions of the Treasury Regulations requiring the taxpayer be given notice of a decision to subordinate a tax lien. On the other hand, there is nothing in the regulations which specifically states that notice to the taxpayer is not required. In fact, it appears, from a reading of §301.6325-1, that the drafters of the regulations did not consider the possibility that such an agreement to subordinate would occur between the IRS and anyone other than the taxpayer. The lack of a notice requirement cannot be viewed, therefore, as an affirmative policy decision on the part of the drafters of the Treasury Regulations. If the drafters of the Regulations did not consider the possibility of subordination agreements with subsequent purchasers of property subject to tax liens, they could not have anticipated the potential for substantial prejudice to the taxpayer. As the District

Court observed, ". . . the smaller burden of notifying the taxpayers of negotiations to subordinate is greatly outweighed by the possibility of actual prejudice resulting from the lack of notice."

In support of the conclusion that the lack of a specific provision requiring the IRS to notify the taxpayer when proposing to enter into a subordination agreement with a third party is due to oversight, is the fact that there is no apparent policy reason which would justify keeping the taxpayer in the dark. In fact, the contrary is true. In such a situation, the taxpayer has the same interest as the IRS, *i.e.*, to maximize the amount of the tax paid from proceeds of the property. The third-party owner of property subject to the tax lien does not care whether the tax liability is paid or not because he has no personal liability. The third-party owner would like to get the tax lien off of the property without paying a cent toward the tax liability which it secures. By giving notice to the taxpayer, the taxpayer may be able to point out objections to the subordination proposal which the IRS has not considered and avoid situations like the present case where the lien was lost because of an unwise decision. There is no valid policy reason for the IRS to maintain that notice should not be given.

The burden of notifying the taxpayer is indeed minimal. On the face of its file, the IRS agent can see that the party requesting subordination is not the taxpayer who is personally liable for the tax, which should alert him to the need to give notice. The IRS also has at its disposal every taxpayer's address as of the filing of the last tax return at the touch of a computer button. It is not unreasonable to require the IRS to make this minimal effort to send notice to the taxpayer.

In view of the fact that the lack of a provision requiring notice to the taxpayer appears to be a result of oversight rather than a statement of Treasury policy, there is no reason to preclude the District Court from exercising its equitable authority to impose a duty to give such notice when necessary to avoid an inequitable result. In this case, the IRS had complete control and discretion over the decision to subordinate its lien and incur the risk of loss of the security connected therewith. The taxpayers were not even aware that the security for their tax obligation was being risked. The IRS took the risk without the taxpayers' knowledge or consent, and lost. It is inequitable now to impose the burden of that loss on the taxpayers. The District Courts are vested with broad equitable powers to fashion an appropriate remedy (*see Lemon v. Kurtzman* (1973) 411 U.S. 192 at 200). While there was no specific statutory requirement in this case to give notice to the taxpayer, it was within the District Court's authority to determine that an equitable duty existed and to impose an appropriate equitable remedy.

> "In shaping equity decrees, the trial court is vested with broad discretionary power; appellate review is correspondingly narrow. *Swann v. Charlotte-Mecklenburg Board of Education* (1971) 402 U.S. 1, 15, 27 n. 10. Moreover, in constitutional adjudication as elsewhere, equitable remedies are a special blend of what is necessary, what is fair, and what is workable. 'Traditionally, equity has been characterized by a practical flexibility in shaping its remedies and by a facility for adjusting and reconciling public and private needs.'

> *Brown v. Board of Education* (1955) 349 U.S. 294, 300). MR. JUSTICE DOUGLAS, speaking for the Court, has said, 'The essence of equity jurisdiction has been the power of the Chancellor to do equity and to mould [*sic*] each decree to the necessities of the particular case. Flexibility rather than rigidity has distinguished it. The qualities of mercy and practicality have made equity the instrument for nice adjustment and reconciliation between the public interest and private needs as well as between competing private claims.' *Hecht Co. v. Bowles* (1944) 321 U.S. 321, 329-330."
>
> *Lemon v. Kurtzman* (1973) 411 U.S. 192, 200-201.

The District Court is this case exercised its equitable jurisdiction to reconcile the conflict between the public interest in having taxes collected and the private needs of a taxpayer in protecting his interests against the possibility that the IRS will take actions which increase the taxpayer's personal expense in discharging the tax liability. The District Court made a determination that equity and fairness demanded that the IRS make the minimal effort to notify the taxpayer before agreeing to subordinate the lien in order that the taxpayer could have an opportunity to mitigate his damages. Failing that, the District Court denied the IRS a judgment against the taxpayers for the taxes.

CONCLUSION

The District Court properly exercised its equitable jurisdiction in denying judgment for the Internal Revenue Service and the exercise of that power is entitled to great weight upon appeal. It is respectfully requested that the Supreme Court grant the Petition for Writ of Certiorari and that the decision of the Court of Appeals for the Ninth Circuit be reversed and remanded with direction that the decision of the District Court for the Central District of California be affirmed.

DATED: October 5, 1990.

McCORMICK, KIDMAN & BEHRENS
A Partnership Including
WILLIAM B. HANLEY, ESQ.
A Professional Corporation

BY: WILLIAM B. HANLEY, ESQ.

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APPENDIX A

NOT FOR PUBLICATION
UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

FILED
JUL 11 1990
Cathy A. Catterson, Clerk
U.S. Court of Appeals

UNITED STATES OF AMERICA,
Plaintiff-Appellant,
v.
EDWARD G. WEBB and
MARILYN K. WEBB,
Defendants-Appellees.

No. 89-55299
D.C. No. CV-87-7842-RG

MEMORANDUM*

Appeal from the United States District Court
for the Central District of California
Richard A. Gadbois, Jr., District Judge, Presiding

Argued and Submitted May 11, 1990
Pasadena, California

Before: HUG, TROTT, Circuit Judges, and REED,** District Judge.

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* This disposition is not appropriate for publication and may not be cited to or by the courts of this circuit except as provided by 9th Cir. Rule 36-3.

** The Honorable Edward C. Reed, Jr., Chief Judge, United States District Court, District of Nevada, sitting by designation.

SUMMARY

The United States appeals the district court's judgment discharging the Webbs' 1980 tax debt because the IRS subordinated its tax lien on property once owned by the Webbs without notifying them. The district court's judgment is reversed and the case remanded with directions to enter the judgment sought by the IRS.

STANDARD OF REVIEW

This court reviews the exercise of a district court's equitable powers under the "abuse of discretion" standard. *See Lemon v. Kurtzman,* 411 U.S. 192, 200 (1973). Whether the doctrine of estoppel applies is a question of law which this court reviews de novo. *Mukherjee v. INS,* 793 F.2d 1006, 1009 (9th Cir. 1986). We review the district court's application of the doctrine for abuse of discretion. *Eilrich v. Remas,* 839 F.2d 630, 632 (9th Cir.) *cert. denied,* 109 S. Ct. 60 (1988).

ANALYSIS

I

The first issue this court must decide is which standard of review should be applied to this matter. The Government argues that the district court applied the doctrine of equitable estoppel and therefore this court may review de novo the district court's decision to determine whether that doctrine applies. The Webbs contend the district court was exercising its equitable powers, and therefore this court must review the decision under the abuse of discretion standard.

Based upon the language of the district court's judgment, it is clear that the district court did not engage in any type of estoppel analysis. The district court noted that there is no statutory basis for requiring the IRS to notify the tax debtors that it was subordinating its lien, but fashioned "in the interest of equity" an equitable duty. The sole reasoning given for creating this duty was the court's view of the burden this would place upon the IRS. The court stated, "In the absence of any binding requirement requiring notice and in the interest of equity, the smaller burden of notifying the taxpayer of negotiations to subordinate is greatly outweighed by the possibility of actual prejudice resulting from the lack of notice." We are convinced the district court intended to exercise equitable powers to reach this result, and we therefore review the district court's judgment for an abuse of discretion.

II

The Webbs cite *Swann v. Board of Education,* 402 U.S. 1, 15 (1971), for the proposition that "[o]nce a right and violation have been shown, the scope of a District Court's equitable powers to remedy past wrongs is broad, for breadth and flexibility are inherent in equitable remedies." While this statement is undoubtedly true, it presumes a legal wrong. This is not consistent with the facts or the law governing the instant case. The IRS had no legal duty to inform the Webbs of the subordination. Thus, the court did not use its equitable powers to fashion a remedy, but to fashion a *duty.* This was an abuse of the district court's discretion. We hold that the IRS did not have a duty, legal or equitable, to inform the Webbs of the subordination.

Since the IRS had no legal duty to inform the Webbs of the intended subordination, the IRS did not breach

any legal duty owed to the Webbs. The partnership of Chula & May was the legal owner of the property in which the IRS held an interest — the tax lien. The IRS was not aware of the agreement between Chula & May and the Webbs, and had no reason to believe that the Webbs retained any interest in the property. The IRS, when requested to subordinate its tax lien to facilitate acquisition of new financing, had the authority to subordinate the lien, and did so believing that its actions were in the best interests of all involved.

From the record, it appears that Chula & May did not honor the contract with the Webbs and apply the funds received from refinancing the debt toward the tax lien. The Webbs did apparently suffer an injury because of this breach of contract. In this proceeding, however, the Webbs received a default judgment against Chula & May. While this judgment may prove to be worthless, it is the Webbs' only remedy, for it was Chula & May's breach of contract which caused the injury, not any conduct of the IRS; and our holding does no more than require the Webbs to be responsible for a legitimate tax debt, due and owing.

CONCLUSION

The IRS acted within the law in granting the subordination, and had no legal duty to notify the Webbs. The district court's judgment is reversed and this matter remanded to the district court to enter the judgment sought by the IRS.

REVERSED AND REMANDED.

APPENDIX B

UNITED STATES DISTRICT COURT
CENTRAL DISTRICT OF CALIFORNIA

FILED
JAN 13 1989
Clerk, U.S. District Court
Central District of California
By Deputy

ENTERED
Clerk, U.S. District Court
JAN 17 1989
Central District of California
By /s/ PLW Deputy

UNITED STATES OF AMERICA,
Plaintiff,
v.
EDWARD G. WEBB,
MARILYN K. WEBB,
Defendants.

Case No. CV 87-7842-RG (Tx)

JUDGMENT

Section 6325(d) of the Internal Revenue Code allows for the district director's discretion to issue a certificate of subordination of the lien. However, the Code is silent on the issue of notice to the taxpayer regarding the subordination. In this case, the resulting damage to the defendants from the lack of notice is substantial and requires an inquiry as to whether equitable principles should block IRS recovery of the remainder of the assessment from the taxpayers.

When the defendants Webb transferred the Mead Avenue property to Chula & May Law Corporation, third-party defendants, the lien obviously remained intact. When the subordination request was presented the court believes that an equitable duty was imposed on the plaintiff to notify and obtain the consent of defendants, who were ultimately responsible for paying the tax, prior to effective subordination. Sufficient funds were generated from the refinancing of the property to pay the entire amount of the tax lien. Had defendants Webb known of the refinance and proposed subordination, they could have asserted their rights under their agreement with Chula & May Law Corporation and informed the IRS of their agreement with Chula & May to pay the tax from the proceeds of any refinancing of the Mead Avenue property. Defendants were deprived of the opportunity to mitigate their liability. In the absence of any binding requirement requiring notice and in the interest of equity, the smaller burden of notifying the taxpayer of negotiations to subordinate is greatly outweighed by the possibility of actual prejudice resulting from the lack of notice. For these reasons judgment on the complaint is ordered for defendants.

/s/ Richard A. Gadbois, Jr.
United States District Judge

DATED: January 13, 1989